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BEFORE THE ARIZONA CORPORATION COMMISSION

COMMISSIONERS

Arizona Corporation Commission

DOCKETED

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JEFF HATCH-MILLER, Chairman
WILLIAM A. MUNDELL
MARC SPITZER
MIKE GLEASON
KRISTIN K. MAYES

DOCKETED BY

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IN THE MATTER OF THE APPLICATION OF
ARIZONA PUBLIC SERVICE COMPANY FOR
AN EMERGENCY INTERIM RATE INCREASE
AND FOR AN INTERIM AMENDMENT TO
DECISION NO. 67744.

DOCKET NO. E-01345A-06-0009

DECISION NO. 68685

OPINION AND ORDER

DATES OF HEARING:

March 20, 21, 22, 23, 24, 27, 28, 29, 2006

PLACE OF HEARING:

Phoenix, Arizona

IN ATTENDANCE:

Jeff Hatch-Miller, Chairman
William A. Mundell, Commissioner
Marc Spitzer, Commissioner
Mike Gleason, Commissioner
Kristin K. Mayes, Commissioner

ADMINISTRATIVE LAW JUDGE:

Lyn Farmer

APPEARANCES:

Mr. Thomas L. Mumaw, PINNACLE WEST CAPITAL CORPORATION; and Mr. William Maledon, OSBORN MALEDON, on behalf of Arizona Public Service Company;

Mr. C. Webb Crockett, FENNEMORE CRAIG, P.C., on behalf of AECC and Phelps Dodge;

Mr. Scott S. Wakefield, Chief Counsel, on behalf of the Residential Utility Consumer Office;

Mr. Jarrett J. Haskovec, LUBIN & ENOCH, on behalf of the International Brotherhood of Electrical Workers Local Unions 387, 640 and 769;

Mr. Timothy M. Hogan, ARIZONA CENTER FOR LAW IN THE PUBLIC INTEREST, on behalf of Western Resources Advocates;

Mr. Michael Grant, GALLAGHER & KENNEDY, on behalf of Arizona Utility Investors Association;

Ms. Laura Sixkiller, ROSHKA, DeWULF & PATTEN, on behalf of UniSource Energy Services;

1 Mr. Lawrence V. Robertson, Jr., MUNGER
2 CHADWICK, on behalf of Southwestern Power Group
3 II, LLC, Mesquite Power, LLC, and Bowie Power
4 Station, LLC;

5 Mr. Jay I. Moyes, MOYES STOREY, on behalf of
6 Arizona Agricultural Group;

7 Lieutenant Colonel Karen White, on behalf of the
8 Federal Executive Agencies; and

9 Mr. Christopher Kempley, Chief Counsel, and Mr. Jason
10 D. Gellman, Attorney, Legal Division, on behalf of the
11 Utilities Division of the Arizona Corporation
12 Commission.

13 **BY THE COMMISSION:**

14 On January 6, 2006, the Arizona Public Service Company ("APS") filed an application with
15 the Arizona Corporation Commission ("Commission") for an emergency interim rate increase and for
16 an interim amendment to Decision No. 67744 (April 7, 2005) ("Application").

17 By Procedural Order issued January 9, 2006, a procedural conference to discuss the process
18 for handling this matter was set for January 12, 2006. The January 12, 2006 procedural conference
19 was held as scheduled.

20 On January 19, 2006, Staff filed a Notice of Filing Proposed Schedule which indicated that
21 Staff, APS and the parties that participated in the procedural conference had agreed upon a
22 procedural schedule. In accordance with that proposal, APS filed supplemental testimony on January
23 20, 2006.

24 By various Procedural Orders, intervention was granted to: Phelps Dodge Mining Company
25 ("Phelps Dodge"), Arizonans for Electric Choice and Competition ("AECC"), the Residential Utility
26 Consumer Office ("RUCO"), the Arizona Utility Investors Association, Inc. ("AUIA"), Arizona
27 Agricultural Group ("AzAg"), Western Resource Advocates ("WRA"), Unisource Energy Services
28 ("UES"), Southwestern Power Group II, L.L.C., Mesquite Power, L.L.C. and Bowie Power Station,
L.L.C. (collectively "Power Group"), Arizona Water Company ("AWC"), the Town of Wickenburg
("Wickenburg"), the Arizona Community Action Association ("ACAA"), the Federal Executive
Agencies ("FEA"), the International Brotherhood of Electrical Workers, AFL-CIO, CLC, Local
Unions 387, 640 and 769 (collectively, "IBEW"), and the Arizona Competitive Power Alliance

1 ("Alliance").

2 On January 27, 2006, a procedural order was issued setting a hearing in this matter.

3 A procedural conference was held on March 14, 2006 to discuss the scheduling of witnesses
4 and other procedural matters. The hearing on this application was noticed as an A.R.S. § 40-252
5 proceeding in order to allow the Commission flexibility to modify its previous decisions.

6 The hearing was held as scheduled on March 20, 21, 22, 23, 24, 27, 28, and 29, 2006. APS
7 presented testimony of Donald Brandt, Peter Ewen, Steven Wheeler, Steven Fetter, Elliott Pollack,
8 David Rumolo, and Donald Robinson. Staff presented testimony of J. Randall Woolridge, Ralph
9 Smith, William Gehlen, and Barbara Keene. RUCO presented testimony from Marylee Diaz Cortez;
10 the Power Group presented testimony of David Getts; AECC presented testimony from Kevin
11 Higgins; and IBEW sponsored testimony of Robert DeSpain.

12 On March 30, 2006, AECC/Phelps Dodge filed its Notice of Filing of AECC Late-Filed
13 Exhibit No. 8 (Supplement to AECC Exhibit No. 7).

14 On April 7, 2006, Staff filed its Closing Brief and its late-filed exhibit S-11.

15 On April 10, 2006, RUCO filed its Post-Hearing Brief.

16 On April 11, 2006, APS, AECC/Phelps Dodge, AUIA, WRA, and the FEA filed their post-
17 hearing briefs.

18 On April 12, 2006, the Power Group filed their Post-Hearing Brief.

19 DISCUSSION

20 In its Application, APS requests an interim rate increase of \$299 million in additional annual
21 electric revenues, or approximately a 14 percent increase, to be effective April 1, 2006, and subject to
22 refund pending the Commission's final decision in APS' pending permanent rate application.¹
23 According to the Application, this increase represents only the higher annual fuel and purchased
24 power costs the Company expects to incur based on 2006 prices as reflected in its January, 2006,
25 updated filing in the permanent rate case, and thus is not an additional increase. Granting the
26 emergency interim rate increase requested in the Application would result in an interim base fuel cost
27

28 ¹ Docket No. E-01345A-05-0816.

1 of \$.031904 per kWh. According the Application, APS earns no markup or profit on fuel and
2 purchased power costs, and these costs are unavoidable and largely uncontrollable. The Application
3 states that the requested interim base fuel rate also reflects expected 2006 operations at Palo Verde
4 and the other APS power plants and is not impacted by any of the 2005 unplanned Palo Verde
5 outages. APS' Application also requests that the Commission amend Decision No. 67744 (April 8,
6 2005) on an interim basis to remove the \$776.2 million "cap" on total retail fuel and purchased power
7 costs recoverable in rates.²

8 APS Position

9 In its rebuttal testimony filed on March 13, 2006, APS modified its request to \$232 million
10 due to declines in fuel prices between November 2005 and the end of February 2006.

11 According the Application, APS is experiencing a substantial operating cash flow deficiency
12 that has already led to one downrating of its debt securities to the bottom rung of the investment
13 grade ladder. According to the Company, this increases its financing costs by approximately ten to
14 fifty basis points and decreases the marketability of its securities. APS believes it is likely that it will
15 be further downgraded to non-investment "junk bond" status for the first time in its over 100-year
16 history of service in Arizona if its interim rate relief to address the "massive under collection of fuel
17 and purchased power costs" is not granted. The Application states that APS would be among the
18 least credit-worthy non-bankrupt utilities in America and the Company's ability to successfully
19 undertake the multi-billion dollar construction program the Company believes is necessary to render
20 adequate utility service to its customers at a reasonable cost would be put in serious jeopardy.

21 Attached to the Company's application is an Affidavit by Donald Brandt, the Executive Vice-
22 President and Chief Financial Officer for both Pinnacle West Capital Corporation ("Pinnacle West")
23 and APS. Mr. Brandt is responsible for the finance, treasury, accounting, tax, investor relations,
24 financial planning and power marketing and trading functions at Pinnacle West and APS. Mr. Brandt
25 testified concerning APS' financial condition and credit ratings. APS must access the capital market
26 to issue debt to fund a portion of the cost of the Company's infrastructure additions and improvement

27 _____
28 ² In Commission Decision No. 68437, the Commission amended Decision No. 67744 and allowed APS to defer costs above the \$776.2 million "cap" pending resolution in this docket.

1 required to meet customer needs, including new and upgraded transmission and distribution facilities,
2 generation plant improvements, new environmental control systems, and other service facilities. The
3 Company's capital expenditure budget for 2006 is approximately \$650 million, and during 2006-
4 2009, capital expenditures are expected to be more than \$3 billion and the Company will need to
5 access the capital markets to issue over \$1 billion of debt to fund the projects that make up the
6 budget.

7 The cost that APS pays for the debt it must issue to fund the capital expenditures is based
8 upon the credit ratings that it is assigned. According to Mr. Brandt, these costs increase dramatically
9 when a Company's credit rating falls to non-investment ("junk") grade level and for that reason he
10 believes that both APS and its customers have a strong interest in maintaining investment grade credit
11 ratings. Mr. Brandt testified that the key financial metric examined by the credit rating agencies is
12 the ratio of Funds from Operations to Debt ("FFO/Debt"). The FFO/Debt measures the sufficiency of
13 a Company's cash flow to service both debt interest and debt principal over time. According to Mr.
14 Brandt, because the Company is unable to collect in a timely manner a significant portion of its fuel
15 and purchased power cost, an imbalance has developed between cash revenue and cash expense,
16 thereby worsening the FFO/Debt ratio.

17 Mr. Brandt testified that in order for a company to maintain a BBB credit rating, Standard and
18 Poor's ("S&P") expects a company to maintain a FFO/Debt of 15 percent to 22 percent for a
19 Business Profile 5 and 18 percent to 28 percent for a Business Profile 6. On December 21, 2005, S&P
20 changed APS from a Business Profile 5 to a 6, reflecting its assessment that APS faces increased
21 regulatory and operating risk. The December 21, 2005 S&P Research Update indicated that "an
22 additional factor contributing to PWCC's weakened business profile is the performance of Palo
23 Verde nuclear units in 2005." S&P also downgraded APS' debt. According to Mr. Brandt, APS'
24 borrowing costs have increased \$1 million per year as the result of this S&P downgrade to BBB -. In
25 addition, APS will incur an incremental 10-50 basis points, or \$100,000 to \$500,000 in additional
26 interest costs per year for each \$100 million of long-term borrowing. Further, Mr. Brandt testified
27 that the downgrade imposed onerous restrictions on the Company's ability to access funds needed for
28 its construction program. Mr. Brandt believes that absent emergency interim rate relief APS will

likely be further downgraded to non-investment grade or junk bond status. Mr. Brandt testified that any further downgrade in APS' credit rating from its current BBB- rating to below investment grade could cause an immediate additional annual increase in interest expense in the range of \$10 million to \$15 million. Further, by 2015, the additional amount of annual interest expense would grow to \$150 million to \$230 million, for a cumulative amount of between \$625 million and \$1.2 billion in additional interest costs.

Mr. Brandt testified that the impact of downgrading from APS' current credit rating to non-investment grade would be costly in the following ways:

- During the next 10 years, APS will need to issue almost \$5 billion worth of additional long term debt to finance essential generation, environmental control, transmission and distribution construction programs, and to refinance existing long-term debt when it matures. As a result, the Company's annual financing costs would increase between \$110 million and \$225 million over what they would have been if APS had not been downgraded to junk status;
- APS' approximate \$539 million of tax exempt debt and the cost associated with this debt would increase an additional \$4 million per year due to increased fees and additional interest.
- Because of the seasonal nature of APS' cash flow, APS relies heavily on commercial paper for its working capital needs. If APS were further downgraded to non-investment grade, its access to the commercial paper market would be eliminated and APS would be turning to its more costly revolving credit agreement to satisfy its daily working capital needs. This would increase APS' overall cost of borrowing by about \$1 million per year.
- Further negative impacts include difficulty renewing existing credit agreements; negative effects to its marketing and trading functions including collateral calls which could place a significant liquidity strain on APS when the Company is least able to access the markets; in addition to cash collateral calls, energy trading counterparties may place other onerous terms on their dealings with a non-investment grade company including prepayments for a large portion of APS' power plant fuel needs, thereby making APS' cost of doing business in the wholesale market increase significantly and making it more difficult to hedge the Company's commodity position.

In his direct testimony, Mr. Brandt testified that the emergency the Company faces includes:

- An unprecedented increase in APS' fuel and purchased power costs since base fuel rates were established in Decision No. 67744 and continuing significant increases in those costs during 2006 due to ongoing exogenous factors and fundamental shifts in the global energy market.

- 1 • Continued cost deferrals in 2006 from the imbalance between fuel costs and cost
2 recovery which has weakened the Company's key financial indicators and a further
3 downgrade according to APS if the Commission does not address fuel cost recovery in
4 a manner that promises to reverse the downward trend in the Company's financial
5 indicators.
- 6 • A credit rating agency downgrade of APS to non-investment grade would increase
7 interest expense in 2006 by at least \$10 to \$15 million, increasing to between \$115
8 and \$230 million by 2015.
- 9 • Credit limitations imposed on APS as a result of a further downgrading would increase
10 the cost of fuel acquisition and purchased power.
- 11 • Once a Company experiences an important credit downgrade, it takes years of
12 sustained positive regulatory action to reverse the situation.
- 13 • Without an interim raising of the \$776.2 million cap, APS will be unable to defer
14 approximately \$65 million in 2006.
- 15 • Pending APS general rate case will possibly not be decided within a "reasonable
16 time".

17 Mr. Brandt testified in his direct testimony that since the Affidavit and Application were filed,
18 S&P issued an additional Research Summary regarding APS and both Moody's and Fitch have taken
19 negative rating actions regarding the Company. According to APS witness Brandt, all three of the
20 rating agencies point directly to the Company's increasingly critical need to recover in a timely
21 manner fuel and purchased power costs prudently incurred to serve its customers as the basis for its
22 negative action. Mr. Brandt testified that the combination of weak cash flow and the resulting need
23 for additional debt will result in a weaker FFO/Debt ratio which will likely cause the downgrade of
24 the Company to junk grade.

25 In his rebuttal testimony, Mr. Brandt states that the Company faces "an emergency situation
26 and critically needs timely action by the Commission permitting the Company to recover its fuel and
27 purchased power costs on a current basis. Without such action, the Company faces a continuation of
28 its cash flow crisis and the very real and substantial risk of a downgrade of its credit ratings to non-
investment 'junk' grade levels." (Brandt rebuttal p. 2) He testified that the recent reports of the credit
rating agencies are clear that the recent "partial relief" granted by the Commission will not cure the
Company's cost-recovery issues. He disagrees with Staff and RUCO witnesses' interpretations of
those reports and believes that they have understated the risk and likelihood of a further downgrade.
Mr. Brandt testified that putting off recovery of these costs "distorts the true cost of electricity,
increases the total amount to be recovered, potentially shifts some of those true costs from current

1 ratepayers to future ratepayers, and raises the very real possibility that ratepayers will be saddled with
2 massive additional interest costs over the next decade if APS' credit ratings suffer a downgrade as a
3 result of a decision by the Commission to defer recovery of these costs." APS exhibit 3, p. 36. At the
4 hearing, Mr. Brandt presented his opinion of how the various proposals affected the risk probability
5 that APS' credit rating would be downgraded to junk.³ He also presented an exhibit that set forth
6 APS' expectation as to what FFO/Debt would be obtained under the various proposals.⁴ Mr. Brandt
7 testified that neither the Staff's nor the AECC/Phelps Dodge proposal is a sufficient alternative to the
8 requested emergency rate relief.

9 Mr. Peter Ewen, Manager of Revenue and Fuel Analysis and Forecast Department for APS,
10 testified concerning the increasing costs of the Company is experiencing. Those costs include:

- 11 • Incremental sales growth and fuel mix. APS has one of the fastest growing territories in the
12 country and growth is one of the dominant factors producing increased fuel and purchased
13 power costs. The Company's incremental sales attributable to growth is met primarily with
14 high cost natural gas and purchased power. This factor alone accounts for \$147 million of the
15 requested interim rate increase.
- 16 • Natural gas prices. Natural gas prices have increased dramatically since 2002 according to
17 Mr. Ewen and coupled with purchased power price increases are responsible for a \$330
18 million increase in the Company's base cost of fuel prior to the results of the hedging
19 program.
- 20 • Purchased Power Prices. Prices for purchased power, most of which comes from natural gas
21 generation also increased significantly.
- 22 • Coal prices. Coal prices increased 13 percent between 2003 and November 2005 and are
23 projected to increase an additional 6 percent in 2006. These higher coal prices have raised the
24 Company's base cost of fuel by \$34 million.
- 25 • Hedging. All of the above price increases would have amounted to an increased fuel expense
26 of approximately \$364 million; however, that amount was reduced by more than \$160 million
27 through APS' hedging program.

28 According to Mr. Ewen, the requested amount reflects expected 2006 fuel and purchased
power prices and corresponding hedging result; a credit for anticipated off-system sales margins; and,
the effects of adding the Sundance Unit to the APS system. Mr. Ewen used the Company's

³ APS Exhibit 6.

⁴ APS Exhibits 4 & 9.

1 production cost simulation tool ("RTSim") to calculate the new base fuel rate. The RTSim is a
2 computer model which replicates the dispatch of the APS system and is the primary fuel expense and
3 off-system sales forecasting tool used by the Company in preparing its annual budgets, long range
4 fuel forecasts, and near term operational plans. In his rebuttal testimony, Mr. Ewen testified that the
5 Company had re-estimated its fuel expenses using February 28, 2006 forward prices and has
6 modified its request downward by \$67 million, to \$232 million.

7 APS rebuttal witness Steven Wheeler testified about "modifications and enhancements" to the
8 Staff and to the AECC/Phelps Dodge recommendations which he believes would decrease the
9 likelihood of rating downgrades and would impact the continued buildup of uncollected fuel and
10 purchased power costs. Mr. Wheeler further testified that he does not agree that resetting the base
11 fuel rate prior to the conclusion of the pending permanent rate case is prohibited by the APS
12 Settlement Agreement or Decision No. 67744.

13 APS witness Elliott Pollack testified that non-investment junk credit rating of a local electric
14 utility will negatively impact businesses' perceptions about Arizona.

15 APS witness Steven Fetter testified concerning comments from the three major credit rating
16 agencies and stated that "[t]o me, S&P's recent press releases about APS indicate that the rating
17 agency is looking for additional support from the Commission for significant near-term cash recovery
18 by APS for its power supply expenditures that were prudently-incurred." APS Exhibit 7, p. 14. He
19 also testified if APS were downgraded to junk status, that there would be a "marked change in the
20 investor profile" for APS and noted that "major utility investors such as insurance companies and
21 pension funds operate under legal restrictions that severely limit their ability to invest in below
22 investment-grade debt instruments, or 'junk bonds'" and that some mutual funds may also be
23 affected. *Id.* at 20. Mr. Fetter advised the Commission that if the Commission views the deferred fuel
24 and purchased power costs as prudently incurred, that he would "strongly encourage action before
25 further degradation of APS' credit ratings occurs. While raising rates to provide such recovery is
26 never a welcome task, there would be a much greater negative impact on customers if their rates were
27 to go up due to a further downgrade of APS into below investment-grade status, while the issue of
28 power supply cost recovery remained looming as a potential further rate escalator." *Id.* at 29.

1 APS witness Donald Robinson testified that the Staff recommendation is consistent with how
2 the parties' viewed the Power Supply Adjustor ("PSA") working under the Settlement Agreement.
3 Mr. Robinson testified that Staff's recommendation allows the PSA to better track changes in fuel
4 costs, which then improves the Company's operational cash flow and resulting financial metrics. He
5 believes that Staff's recommendation to allow surcharges would better match the payment of costs
6 with the customers incurring those costs and would provide a better signal to customers concerning
7 the cost of their use of energy and the value of conserving energy. At the hearing, Mr. Robinson
8 testified about the Company's expenses related to advertising and bonuses for its officers in response
9 to questions by Commissioners.⁵

10 APS witness Rumolo testified and presented exhibits on the bill impacts of the requested
11 increase.

12 RUCO's Position

13 RUCO presented one witness, Marylee Diaz Cortez, on its behalf. Ms. Diaz Cortez testified
14 that APS' Application does not reflect an emergency at this time. Ms. Diaz Cortez testified that prior
15 to the issuance of Decision No. 68437 (February 2, 2006), there might have been a case to debate
16 over whether APS' condition was such that its ability to maintain service pending a formal rate
17 determination was in serious doubt, but since the issuance of that decision, there are no grounds for
18 finding an emergency. Ms. Diaz Cortez testified that there is no longer any basis for a perception by
19 the rating agencies that the Commission will not deal with the growing deferrals in a timely manner
20 and so the threat of an imminent downgrade to junk bond status is reduced. Ms. Diaz Cortez cites
21 S&P's statement in December 2005 and the fact that since the Commission voted on Decision No.
22 68437, two of the rating agencies have indicated that their present investment grade ratings are stable.
23 Ms. Diaz-Cortez testified that on "January 26, 2006, S&P affirmed its current BBB -, even though
24 two days earlier it had reported that it appeared unlikely the Commission would grant the pending
25 emergency rate application." RUCO exhibit 5, p. 7. Also, while Fitch downgraded APS' rating for
26 senior unsecured debt from BBB + to BBB on January 30, 2006, it reported a stable ratings outlook.
27

28 ⁵ See letters from Commissioner Mayes on January 11, 2006, and February 1, 2006.

1 RUCO concluded that the rating agencies view Decision No. 68437 as adequate to maintain APS'
2 current investment grade ratings.

3 Ms. Diaz Cortez testified that since there is no emergency, rates cannot to be changed without
4 a finding of fair value. She further testified that APS did not present evidence that it would be unable
5 to continue to provide electric service absent emergency interim rate relief, citing APS' testimony
6 that the deferrals have constrained only 20 percent of its equity returns. Ms. Diaz Cortez testified that
7 RUCO's position is that "granting an emergency interim rate increase at this juncture would
8 substantially change the terms of the settlement agreement and Decision No. 67744" because fuel and
9 purchased power under or over recoveries were to be shared 90/10 between stockholders and
10 ratepayers. *Id.* at 9. An emergency interim rate request would circumvent the sharing mechanism and
11 result in 100 percent of the under-recovered fuel and purchased power cost being borne by
12 ratepayers, thereby changing the terms of the settlement agreement and Decision No. 67744, and
13 would harm ratepayers.

14 At the hearing, Ms. Diaz Cortez testified that RUCO supported the Staff recommendation for
15 surcharges. Tr. p. 1692. She explained that "we may not have given it (PSA) all the characteristics it
16 needed to deal effectively with such large escalating fuel prices and that maybe in this proceeding
17 that something we might want to contemplate doing is amending that adjustor mechanism that we put
18 in place back in April '05 so that it can deal effectively with the level of escalation that has actually
19 come to be." Tr. p. 1695.

20 In its Post-Hearing Brief, RUCO stated that the deferred fuel balance is growing and could
21 become problematic and that the Commission should modify the PSA to provide more timely
22 recovery of fuel costs. RUCO supported Staff's quarterly surcharge proposal.

23 AECC/Phelps Dodge's Position

24 Phelps Dodge Mining Company and Arizonans for Electric Choice and Competition
25 ("AECC/Phelps Dodge") sponsored testimony of their witness, Kevin Higgins, in this proceeding.
26 Mr. Higgins testified that in light of rising fuel and purchased power costs and the recent downgrade
27 experienced by APS, some emergency relief is warranted. Mr. Higgins believes that an emergency
28 interim increase sufficient to allow APS to attain a FFO/Debt ratio of 18 percent in 2006 is

1 appropriate. He recommends that the ratio can be obtained through an emergency interim rate
2 increase of \$126 million in calendar year 2006. If this rate increase were implemented on May 1,
3 2006, revenue could be collected with an increase of approximately 7.8 percent. Mr. Higgins
4 disagrees with APS' proposal to establish a new base energy rate in this proceeding as it would allow
5 APS to avoid having to absorb its 10 percent share of the cost differential between the current base
6 energy rate and its new proposed energy rate. Mr. Higgins proposes that the base energy rate should
7 remain at the level established in APS' last general rate case and any revenues collected from the
8 emergency surcharge should be applied as a credit against the PSA annual tracking account. This
9 would recover the 90 percent cost share assignable to customers with the remaining 10 percent
10 assigned to APS in accordance with the PSA mechanism. Under this recommendation, the new base
11 energy rate would then be established in the pending general permanent rate case.

12 Mr. Higgins also opposed APS' proposed interim surcharge rate design. According to Mr.
13 Higgins, although APS has stated that the proposed increase would be a 14 percent increase, Mr.
14 Higgins believes that the Company's proposal would actually raise rates for many industrial
15 customers by more than 20 percent. He believes that it is inappropriate in the context of an
16 emergency rate filing with a limited record and restricted opportunity for analysis, to put in place
17 disproportionate increases on different customer groups. He recommends that the only appropriate
18 rate design would be an equal percentage increase for all customer groups and that this could be
19 achieved through an equal percentage surcharge on total customer bills exclusive of PSA charges.

20 During the hearing, Mr. Higgins modified his \$126 million surcharge recommendation in
21 response to APS' rebuttal testimony that included decreased net fuel costs. However, as testified to
22 by APS witness Brandt, the expected extended summer 2006 Palo Verde outage would cancel out the
23 fuel cost reduction. In its Post-Hearing Brief, AECC/Phelps Dodge readjusted its recommended
24 increase back to its original \$126 million amount, indicating that using the Palo Verde outage costs to
25 determine the amount needed to reach the targeted FFO/Debt ratio does not "constitute *de facto*
26 prudence determination", nor will it allow the company to recover those costs, as the recommended
27 emergency surcharge will only flow to the PSA Tracking Account as a credit against costs found to
28 be prudent by the Commission.

1 The Power Group's Position

2 The Power Group sponsored testimony of David Getts, the Chief Financial Officer of
3 Southwestern Power Group II, L.L.C. The Power Group supports the level of emergency interim rate
4 relief that APS is able to demonstrate is necessary to maintain securities and financial instruments of
5 investment grade quality. The members of the Power Group are competitors in the wholesale electric
6 market in Arizona and APS is the largest potential purchaser of capacity and energy in the market.
7 Mr. Getts testified that APS' creditworthiness can have a direct effect on the terms and conditions
8 offered to it, because when APS' credit is at risk, that risk affects the financial exposure and profile
9 of the supplier. This means that the price offered to APS will be higher, and the terms and conditions
10 more stringent. Those costs, if prudent, will ultimately be passed on to customers.

11 IBEW' Position

12 The IBEW sponsored the testimony of its witness, Robert DeSpain, who testified that the
13 situation APS is in was not caused by the level of compensation that it pays its employees.

14 Staff's Position

15 Staff provided testimony of Ralph Smith, Jay Randall Woolridge, Barbara Keene, and
16 William Gehlen. Mr. Smith testified that the Commission's cap of \$776.2 million does not currently
17 constitute a financial emergency for APS because APS has not yet incurred fuel and purchased costs
18 in excess of the cap and Decision No. 68437 has allowed APS to defer fuel and purchased power
19 costs in excess of that cap. Mr. Smith recommends that APS should be allowed to defer fuel and
20 purchased power costs in excess of the cap in 2006 with the actual costs incurred by APS being
21 reviewed for whether they were prudently incurred.

22 Mr. Smith testified that APS has not proved that a \$299 million emergency rate increase is
23 needed because it has not demonstrated that that rate relief would: prevent future downgrades of
24 APS' debt ratings; result in an upgrade of APS' debt ratings; result in lower long-term costs for its
25 customers; or be appropriate under the circumstances.

26 In his direct testimony, Mr. Smith cites two reasons why the requested emergency rate
27 increase would not necessarily prevent future downgrades: "emergency" rate increases are subject to
28 refund; and other factors such as a sustained, unplanned outage at an APS plant during a peak

1 demand period could result in a downgrade. He also points out that hitting a particular FFO/Debt
2 ratio does not dictate a certain bond rating. Mr. Smith testified that granting an emergency rate
3 increase as a way to provide for APS to collect fuel and purchased power costs is not a preferred
4 alternative because it would be based on forecast estimates of fuel costs under collections rather than
5 collection of actual costs already incurred; it would likely require incurring additional costs for a
6 surety bond; APS has not proven that it is currently experiencing a financial emergency or cash flow
7 crisis; and there is no assurance that increasing APS' rates by \$299 million subject to refund would
8 result in a bond rating upgrade or prevent a bond rating downgrade. Mr. Smith agreed that a
9 downgrading of APS' debt to junk status would not be a desirable outcome because in addition to
10 resulting in increased borrowing costs, it would impede the Company's access to credit.

11 Rather than grant APS emergency rate relief that is not needed, Staff recommended that the
12 Commission should address any deferred fuel balances through means of quarterly surcharges. Staff
13 testified that prompt action on the PSA surcharge request is a better and more appropriate way to
14 address the Company's growing deferred fuel balance than the Company's request for emergency
15 rate relief. Staff recommends that the functioning of the PSA be reviewed in the current APS rate
16 case and be revised if necessary when additional operating expenses in 2006 can be taken into
17 consideration. In the interim, in order to address any potential for growing fuel costs under collection
18 that APS anticipates for 2006 and as the preferable alternative to an emergency rate increase, Staff
19 recommended that the Commission allow APS to file for PSA surcharge request in 2006 on a
20 quarterly basis if necessary. Commission Staff is willing to expedite the processing of the surcharge
21 request by filing its recommendation no later than 30 days after APS' filing. Mr. Smith testified that
22 allowing APS to make quarterly PSA surcharge filings if necessary in 2006 could function as a
23 "safety valve" against financial pressure from carrying large deferred balances building to an
24 emergency situation. He testified that it could help thwart an emergency situation from occurring
25 later this year and could provide both the Commission and the Company with a ready means to
26 address and prevent a potentially serious situation.

27 Staff recommends that regardless of whether an emergency rate increase is granted, the
28 Commission should temporarily impose some additional reporting safeguards on APS in order to

1 monitor any deterioration in APS' financial condition. Staff recommended that APS file monthly
2 reports on APS' and Pinnacle West's cash position and financial ratios, their cash flow projections
3 for the upcoming 12 months and notify the Commission immediately if any event occurs or is
4 projected by APS to occur within the next 12 months which would constitute a default condition. Mr.
5 Smith testified that this would enable the Commission to have an additional means of keeping
6 apprised of any possible deterioration in APS' cash and financial situation.

7 Staff witness Dr. Woolridge testified concerning the impact of the recent bond rating
8 downgrade on APS' financial condition, the cost of capital, ability to raise capital, and the
9 Company's customers; an assessment of whether the downgrade constitutes a financial emergency;
10 an evaluation of a likelihood of additional downgrades of APS' debt; and the impact of any such
11 additional downgrade. Dr. Woolridge testified that although the downgrading of the Company's
12 bonds certainly is not positive for the Company, recent reports from rating agencies and investment
13 firms suggest that recent Commission actions appear to have stabilized the situation. Staff exhibit 1,
14 pp. 2-3. Those agencies and firms reacted positively to the January 25, 2006 Commission decision to
15 lift the cap on deferred costs and to advance the collection of deferred costs.

16 Dr. Woolridge discussed the role of financial ratios and the rating process and indicated that
17 rating agencies consider many factors. These factors include many business risk indicators such as
18 economic conditions of the service territory, competitive environment, regulatory climate, customers,
19 and exposure to unregulated businesses. Ratio analysis is also part of the credit risk analysis
20 performed by rating agencies.

21 Dr. Woolridge testified that it is important to note the fact that the ratios published by rating
22 agencies for different bond ratings are not strict standards which must be met to achieve a particular
23 bond rating. He also noted that of the three ratios reported by S&P, the only APS ratio that violates
24 its guidelines for the BBB rating is FFO/Debt, with the other ratios falling within the range specified
25 for S&P for a BBB rating. Dr. Woolridge testified that he does not believe the bond downgrading
26 has restricted the Company's access to capital and the Company has presented no evidence to support
27 that assertion. He testified that if the Company were to be downgraded to junk status, such an event
28 would restrict the Company's access to capital. He further testified the Company has not presented

1 any evidence that its bonds are about to be downgraded to junk status and noted that the rating status
2 of the bonds by S&P, the only agency that has the Company's bond rating one notch above junk
3 status, is stable. Dr. Woolridge did note that the downgrading of the Company's bonds to BBB – by
4 S&P has caused a slight increase in the Company's overall cost of capital and his analysis indicates
5 that as of January 2006, it was at 15 point basis points.

6 Staff witness Barbara Keene set out the various rate impacts on customer bills for each of the
7 requested rate increases, surcharges and emergency rate increase requests. At the hearing, she
8 testified that pursuant to Decision No. 67744, low-income customers on the E-3 and E-4 low-income
9 discount rates do not pay either the adjustor rate or any surcharges.

10 Staff also presented the testimony of William Gehlen. Mr. Gehlen testified that Staff
11 evaluated the assumptions APS used in calculating the various projections for uncollected fuel and
12 purchased power expenses for 2006. Mr. Gehlen testified that the Company has developed a hedge
13 implementation strategy with the intent to manage price risks that has been caused by increased
14 volatility in the natural gas and purchased power markets. The Company has hedged 85 percent of its
15 2006 natural gas and purchased power requirements and so the projected uncollected fuel and
16 purchased power cost changes are limited. Mr. Gehlen testified because of hedging, the greatest
17 impact on fuel and purchased power expenses would be the loss of a nuclear or coal, base unit
18 resource during the peak June through September period. APS would become even more reliant on
19 its gas generating unit as well as the purchased power market which is indexed to the price of natural
20 gas. Mr. Gehlen testified that this would result in a dramatic increase in gas and purchased power
21 costs. Staff concluded that APS' projections for uncollected fuel and purchased power expenses are
22 reasonable.

23 EMERGENCY RELIEF

24 Legal Standard

25 The Commission's authority to grant a utility emergency rate relief is part of its constitutional
26 ratemaking authority, which has been construed as plenary and exclusive. Ariz. Const. art. 15 § 3;
27 *Arizona Corp. Comm'n v. State ex rel Woods*, 171 Ariz. 286, 830 P.2d 807 (1992); *State v. Tucson*
28 *Elec. Light and Power Co.*, 15 Ariz. 294, 138 P. 781 (1914). In *Scates v. Arizona Corp. Commission*,

1 118 Ariz. 531, 578 P.2d 612 (1978), the court discussed the Arizona Attorney General's Opinion No.
2 71-17 ("Attorney General Opinion") and the limited circumstances where interim rates should be
3 used: when an emergency exists; when a sufficient bond has been posted guaranteeing refunds to
4 customers if the rates are later found to be excessive; and when the Commission will be making a
5 final determination of just and reasonable rates after a valuation of the utility's property. The parties
6 cite the Arizona Attorney General Opinion for criteria to determine whether an emergency exists.

7 The Opinion says:

8 The foregoing authorities make it clear that, in general, courts and regulatory
9 bodies utilize interim rates as an emergency measure when sudden change brings
10 hardship to a company, when a company is insolvent, or when the condition of the
11 company is such that its ability to maintain service pending a formal rate
12 determination is in serious doubt.

13 In addition, under the *Mountain States Telephone* case, *supra*, the inability of
14 the Commission to grant permanent rate relief within a reasonable time would be
15 grounds for granting interim relief.

16 Perhaps the only valid generalization on this subject is that interim rate relief
17 is not proper merely because a company's rate of return has, over a period of time,
18 deteriorated to the point that it is unreasonably low. In other words, interim rate
19 relief should not be made available to enable a public service corporation to ignore
20 its obligations to be aware of its earnings position at all times and to make timely
21 application for rate relief, thus preserving its ability to render adequate service and to
22 pay a reasonable return to its investors.

23 APS argues that the language of the AG's opinion merely gives examples of situations
24 requiring emergency relief, and that they are not the only circumstances that may constitute an
25 emergency. In its March 13, 2006 filing addressing the legal criteria for emergency or interim relief,
26 APS argues that the "undisputed unexpected large increases in fuel and purchased power cost
27 constitute 'sudden hardship' of an extreme nature to the company. The evidence is that as a
28 consequence of those increased costs and the inability of the company to obtain timely permanent
relief, there is a real threat to the company's credit rating, which already has been recently
downgraded. Finally, the undisputed evidence is that the company and its ratepayers will suffer
substantial consequences if further downrating occurs." APS March 3, 2006 filing, p. 4. APS notes
that the Attorney General's Opinion "did not conclude that emergency relief may be justified only by
past economic events; no such limit is even suggested by the opinion." *Id.* p. 3. APS also discusses

1 and summarizes Commission and other jurisdiction's decisions allowing emergency relief for
2 prospective costs.

3 AECC/Phelps Dodge agrees with APS that the list in the Attorney General's Opinion was not
4 intended to set forth the only conditions upon which the Commission could approve emergency
5 interim rate relief. Citing several Commission decisions,⁶ AECC/Phelps Dodge states that the
6 Commission has granted emergency interim rate relief "not only in situations where only historical
7 costs were evaluated, but also in situations where prospective costs threatened to severely impact the
8 utility in a negative way." AECC/Phelps Dodge Post-Hearing Brief, p. 3. AECC/Phelps Dodge
9 concludes that "Arizona law, and Commission precedent, support the conclusion that the
10 Commission has sufficient authority to grant emergency interim rate relief when prospective costs are
11 considered part of the circumstances that warrant an emergency." Id.

12 Staff argues that the Commission has broad discretion whether to grant emergency rate relief.
13 In its brief, Staff states that while *Residential Utility Consumer Office v. Ariz. Corp. Comm'n*, 199
14 Ariz. 588, 20 P.3d 1169 (App. 2001) requires that an emergency must exist to grant APS the relief it
15 requests, the question of what qualifies as an emergency is largely a question of fact for the
16 Commission to decide. Staff stated in its March 13, 2006 Prehearing Brief that the Commission's
17 authority to grant emergency rate relief "should not be limited to specific, narrowly tailored sets of
18 facts, but should instead be focused upon whether the application alleges circumstances sufficiently
19 urgent to concern the interests of the public."

20 The FEA disagrees with APS' position that the Attorney General Opinion is "merely
21 instructive". FEA Post-Hearing Brief p. 5. It cites subsequent Commission decisions and argues that
22 the Commission has interpreted the Attorney General's Opinion as setting forth criteria to evaluate
23 when determining whether an emergency situation exists. The FEA believes that the Commission
24 should determine whether interim emergency rates are appropriate under the framework set out in the
25 Attorney General's Opinion and subsequent case law and Commission decisions.

26
27
28 ⁶ Decision No. 67990 (July 18, 2005) Sabrosa Water Company; Decision No. 65914 (May 16, 2003) Pine Water
Company; Decision No. 62651 (June 13, 2000) Thim Utility Co.

1 RUCO asserts that Arizona courts would “likely narrowly interpret the Commission’s
2 authority to determine that an emergency exists and that an exception to the requirement to set rates
3 only upon making a finding of fair value is justified.” RUCO Post-Hearing Brief, p. 5.

4 Factual Evidence Necessary for Emergency Finding

5 In its brief, APS states that the emergency that justifies the “interim rate relief arises from the
6 perilous financial situation created by the extremely large – and growing – imbalance between the
7 Company’s fuel and purchased power costs and its current rate revenues.” APS Post-Hearing Brief p.
8 1. APS also asserts that there is a “significant risk” that S&P and other credit rating agencies will
9 further downgrade APS if the Commission does not permit “‘timely and full’ relief from its mounting
10 unrecovered fuel and purchased power costs.” APS witnesses testified that a further downgrade
11 would be financially disastrous for APS, its customers and shareholders, and would have an adverse
12 impact on the state’s economy.

13 AECC/Phelps Dodge believes that rising fuel and purchased power costs, the recent
14 downgrade, and the outlook for APS’ FFO/Debt ratio in 2006 are sufficient reasons to provide
15 emergency relief in order to avoid a further downgrade.

16 The Power Group points to evidence that if APS is downgraded to “junk”, it would have an
17 increase of between \$600 million and \$1.2 billion in its cost of capital, and its access to the capital
18 markets would be severely restricted or foreclosed at a time when it needs to make substantial capital
19 improvements. It adds that operating expenses, including higher prices for fuel and purchased power
20 and the imposition of restrictive credit terms and conditions, would also be ultimately borne by APS
21 ratepayers.

22 The AUIA cites to the “‘sudden change’ in its (APS’) fuel and purchased power costs, the
23 December/January rating agency business position and rating downgrades, current and expected
24 deferral levels, resulting impacts on its FFO to Debt Ratio and likely drop to ‘junk’ status” as
25 “hardships” to the company. AUIA Post-Hearing Brief p. 5. AUIA also pointed to APS witness
26 Wheeler’s testimony and concluded that “APS’ ability to provide ‘adequate service’ is likely to be
27 adversely impacted and the Commission cannot act quickly enough on the general rate case to affect
28 that result this year.” Id.

1 The FEA argues that APS provided “no evidence that a ‘sudden condition’ caused the
2 growing deferrals of fuel and purchased power costs.” FEA Post-Hearing Brief, p. 8. Nor has APS
3 claimed that it is insolvent, facing a liquidity crisis, or unable to provide service to its customers. The
4 FEA concludes that APS has not met the criteria that would allow implementation of interim
5 emergency rates.

6 Staff reviewed recent Commission emergency rate proceedings and concluded that in the
7 majority of the cases where the Commission approved emergency interim rate relief, the utility’s
8 crisis had already occurred or was occurring. Staff stated that the Commission is not bound to find an
9 emergency when only certain parameters are met, but should look to the totality of the facts. Under
10 Staff’s analysis, the facts and circumstances do not justify a finding of an emergency.

11 Staff cites the testimony that there is no threat of insolvency or a liquidity crisis if the request
12 is denied, and Staff disagrees with APS’ assessment that the credit rating agencies’ written reports
13 indicate that a downgrade is imminent. Staff believes that the written reports themselves should be
14 given more weight than APS witness Brandt’s testimony about his conversations with rating agency
15 personnel. Staff also notes that APS did not testify that it would be unable to continue to provide
16 adequate and reliable service pending resolution of the permanent rate case. In its brief, Staff states
17 that since “the concern of the rating agencies is over the PSA, then the direct solution is to address
18 the PSA, either by allowing a quarterly surcharge or by increasing the 4 mil bandwidth rather than to
19 implement emergency rates when no emergency exists.” Staff Post-Hearing Brief p. 7.

20 RUCO argues that rating agency comments do not create an emergency, and that the
21 Commission should focus on setting just and reasonable rates. If the Commission were to consider
22 the rating agencies opinions, RUCO believes that it is not clear that a downgrade to noninvestment
23 status is as likely as APS initially suggested. RUCO notes that APS’ testimony focused on only one
24 of the three credit metrics, and that S&P considers other factors, including the “effectiveness of
25 liquidity management, corporate governance practices, and the regulatory environment.” RUCO
26 Post-Hearing Brief, pp. 7-8. RUCO also noted that the performance of Palo Verde is another factor
27 that affects the credit rating and it is out of the Commission’s control. Further, RUCO argues that the
28 Commission’s recent decisions to allow APS to begin recovering under its annual adjustor two

1 months early and to approve a surcharge have adequately mitigated the rating agencies' concerns.
2 RUCO argues that if S&P "truly expected that denial of interim rates would result in a downgrade, it
3 would not declare its current rating stable two days after stating that it does not appear likely that
4 emergency rates would be approved." RUCO Post-Hearing Brief, p. 11. RUCO's review of the
5 testimony about the credit rating reports leads it to conclude that no rating agency is threatening an
6 imminent downgrade of APS' credit rating to non-investment grade.

7 OTHER RELIEF

8 Although Staff believes that no emergency exists to warrant an interim emergency rate
9 increase, Staff does believe that the concern over the growing large deferred fuel and purchased
10 power costs in 2006 is legitimate and warrants Commission action. Staff believes that the
11 fundamental concerns over timing and certainty are best addressed by modifying the PSA
12 mechanism. Staff's recommendation is for a quarterly surcharge process whereby beginning in June
13 2006, APS would file a surcharge application to recover actual deferred costs. Under Staff's
14 proposal, unplanned outage costs would not be included; all fuel and purchased power costs would be
15 subject to a prudence review at a later time; the FFO/Debt ratio would improve to 16.6; and low
16 income customers would be exempted from the surcharges. RUCO supports Staff's proposal, but
17 does not support the APS recommended modifications, including making the surcharge automatic,
18 without prior review.

19 Staff also sees some merit in the AECC/Phelps Dodge proposal, finding it an improvement
20 over the company's request. The positive aspects are the timing, it preserves the 90/10 sharing
21 agreement, and that there is only one rate impact. The negatives are that it is an emergency rate
22 increase and is directly targeting and depends on meeting a specific FFO/Debt ratio of 18 percent.
23 Staff recommends that the Commission should set just and reasonable rates using a traditional
24 regulatory model.

25 Another method of modifying the PSA would be to expand the bandwidth of the annual
26 adjustor.⁷ Staff believes that the increased bandwidth proposal is also a reasonable way to achieve
27

28 ⁷ See, letters from Commissioner Gleason March 8, 2006, and from Chairman Hatch-Miller, March 23, 2006.

1 fuller and timelier recovery of deferred costs. Staff notes that: it is not an emergency rate per se; it
 2 can be readjusted if appropriate in subsequent proceedings; it can likely go into effect on May 1,
 3 2006; it requires only one adjustment; the 90/10 sharing is preserved; it adjusts the bandwidth directly
 4 addressing the credit rating agencies' concerns; and because this proceeding was noticed as a A.R.S §
 5 40-252 proceeding⁸, can be adopted at this time. RUCO believes that this proposal could recover the
 6 existing and projected deferred costs for a single year, but its once-a-year implementation makes it
 7 less flexible in dealing with what could be an on-going problem of under-recovery.

8 ANALYSIS

9 Much testimony at the hearing concerned whether and under what certain circumstances a
 10 credit rating downgrade would occur. Language from the credit rating agencies' reports, bulletins,
 11 and updates was picked apart, "placed into context", explained and analyzed. The bottom line is that
 12 no party or the Commission will know what action, if any, will be taken or when, because those
 13 actions depend on future undetermined events and actions of entities not involved in this proceeding.

14 As a Commission, our role is to evaluate the Company's application from the broad
 15 perspective of not only what is in the Company's best interests, but also what is in the public's best
 16 interest. Although APS is appropriately concerned about its credit rating, deflecting responsibility for
 17 the position that APS has gotten itself⁹ into does nothing to show the credit rating agencies that it
 18 should expect "sustained regulatory support" from the Commission. APS wants us to believe that our
 19 actions alone will determine the Company's future, when in fact, APS' internal decisions and its
 20 ability to manage its operations and respond to change is what fundamentally determines how it
 21 performs. It is in the best interests of all stakeholders, including APS management, shareholders,
 22 ratepayers, and the state, that APS continues to provide reliable service at reasonable rates.

23 Arizona law allows limited exception to the Constitution's requirement that rates should be
 24 set in conjunction with making a finding of fair value of the utility's property.¹⁰ One of those
 25 exceptions is for emergency rates, and another exception that allows rates to increase without making
 26

27 ⁸ See March 14, 2006 procedural conference transcript.

28 ⁹ APS agreed to base costs that it knew were probably insufficient and did not appeal the Commission's decision approving the settlement agreement with significant modifications to the PSA.

¹⁰ Ariz. Const. art. 15, § 14; *Scates, Residential Utility Consumer Office v. ACC*.

1 a fair value finding is with automatic adjustment clauses. The parties have aptly set forth the
2 applicable law concerning emergency rates and have differing views as to whether the facts presented
3 rise to the level of an "emergency". Applying the conditions discussed in the Attorney General's
4 Opinion, it is clear that APS is not insolvent. It is also clear that APS is able to maintain service
5 pending a formal rate determination, albeit at a potentially higher cost. All of the parties seem to
6 agree that APS is facing hardship because it has incurred and paid for substantial amounts of fuel and
7 purchased power that it has not yet been able to recover through its current rate structure. The parties
8 do not agree as to whether this "hardship" was the result of a "sudden change" as discussed in the
9 Attorney General's Opinion. The parties also do not agree as to whether the possibility of a future
10 downgrade is a sudden change causing hardship.

11 We agree with Staff that our authority to determine emergencies is not limited to specific,
12 narrowly tailored facts, and that our ratemaking authority is sufficiently broad to enable us to grant
13 relief tailored to many different situations. In some situations, that may be to grant emergency rate
14 relief, and in other situations, the circumstances or public interest may require other forms of relief.
15 Although not specified in the Attorney General's Opinion, we believe that another important factor in
16 evaluating whether an emergency exists is whether there is some other form of relief that would
17 address the asserted emergency besides the extraordinary remedy of interim emergency rates. APS'
18 existing rate structure already has incorporated one exception to the constitutional fair value finding
19 requirement in the form of the PSA mechanism. The PSA was established to address the very
20 "emergency" asserted by APS, recovery of deferred fuel and purchased power costs. Given the
21 existence of the PSA mechanism and our ability to modify it in this proceeding, we find that no
22 "emergency" exists. We can address the hardship that APS is facing through modifications to the
23 PSA mechanism and therefore, there is no reason to invoke another exception to the constitutional
24 requirement by implementing emergency rates.

25 Although we find that an "emergency" does not exist, we do agree that some action should be
26 taken to insure more timely recovery of APS' prudent fuel and purchased power costs. Taking action
27 now will benefit APS ratepayers in the long run by: reducing the amount of interest accruing on
28 deferred costs and thereby the amount that ratepayers will pay; by sending more timely and accurate

1 messages to ratepayers as to the actual costs that are being incurred, thereby allowing them to adjust
 2 their consumption; and by increasing the likelihood that APS will remain investment grade and
 3 thereby maintain the lower capital costs that current rates are based upon.

4 Although we find merit in Staff's proposal to allow periodic surcharges to collect deferred
 5 costs, we believe that the timing will not significantly reduce the interest that accrues, nor will it give
 6 a very timely price signal that costs have increased and are being incurred. Multiple price changes in
 7 a short period of time can be confusing to ratepayers and may not send the appropriate price signals.
 8 The primary benefit of Staff's proposal is that the costs are not recovered until they are known and
 9 incurred. However, under Staff's surcharge proposal, Staff's review is not intended as a prudence
 10 review, but will just verify calculations and make sure unplanned outage costs are excluded. Tr. p.
 11 2194 No party testified that APS' purchased power and fuel costs will be at or near the base costs
 12 established in Decision No. 67744, and in fact, APS is 85 percent hedged for 2006.

13 Accordingly, in order to prevent the continued build up of a large balance in the 2006
 14 Tracking Account and the amount of interest that will accrue that will need to be collected from
 15 ratepayers beginning in February 2007, we will allow APS to implement an interim PSA adjustor to
 16 collect a portion of the 2006 purchased power and fuel costs that are above the base cost established
 17 in Decision No. 67744. We believe that this adjustor should be set to collect an amount that will
 18 leave no more than approximately \$110 million (or the amount that will be collected using a 4 mil
 19 bandwidth starting in February 2007 once the 2005 adjustor ends) in the 2006 Tracking Account at
 20 the end of December 2006.

21 Accordingly, we will authorize an interim PSA adjustor for 2006 costs using a bandwidth of 7
 22 mil beginning May 1, 2006.¹¹ This will increase the monthly median residential summer customer
 23 bill by \$5.73 and the monthly average residential summer customer bill by \$7.33. The monthly
 24 median residential winter customer bill would increase by \$3.72 and the monthly average residential
 25 winter customer bill by \$4.74.¹² Pursuant to Decision No. 67744, low-income customers on the E-3

26 ¹¹ Amount of expected unrecovered purchased power and fuel costs for 2006 of \$248 million, APS schedule 18(D), less 4
 27 mil bandwidth recovery of at least \$110 million in adjustor implemented in February 2007, leaving approximately \$138
 28 million for recovery through interim PSA adjustor in 2006. The interim PSA adjustor should continue until all 2006
 Annual Tracking Account costs are recovered except the amount needed for the February 2007 4 mil bandwidth adjustor.

¹² Staff exhibit 9.

1 and E-4 low-income discount rates do not pay either the adjustor rate or any surcharges, and will not
2 pay this interim PSA adjustor rate.

3 APS should include a separate schedule for this interim PSA adjustor in its monthly PSA
4 filings and Staff should monitor on an ongoing basis whether APS is correctly accounting for the
5 recovery. The amounts collected through the interim PSA adjustor, including any costs associated
6 with unplanned outages, will remain subject to a prudency review at the appropriate time. In
7 addition, all unplanned Palo Verde outage costs for 2006 should undergo a prudence audit by Staff.
8 In the event that Staff or any party believes that APS is not implementing the interim PSA adjustor
9 correctly, they should promptly notify the Commission.

10 By acting now, rather than waiting until February 2007 to begin collecting these costs, the
11 ratepayers will be paying approximately five million dollars less in interest charges.¹³ Further, it is
12 important to highlight that this interim modification to PSA will not affect APS' earnings, it will only
13 affect the timing of the already authorized recovery of prudent costs paid for fuel and purchased
14 power.¹⁴

15 This modification of the PSA is an interim measure taken to address what we see as a
16 significant and growing deferral of fuel and purchased power costs. We expect the parties in the
17 pending permanent rate proceeding to propose modifications to the PSA that will address on a
18 permanent basis, the issues with timing of recovery when deferrals are large and growing. We also
19 expect the parties to explore other ways to implement a PSA and/or other tariffs that will give more
20 accurate feedback in pricing terms, so that customers can modify their energy consumption in
21 response to price.

22 When the Commission approved the PSA in Decision No. 67744, the 90/10 sharing
23 mechanism was viewed as an important benefit for customers, particularly the use of off-system sales
24 margins to offset the PSA balance. Because the adoption of the PSA entailed a shifting of risk from
25 shareholders to ratepayers that fuel and purchased power costs would increase over the level
26 established in base rates, the credit of off-system sales margins, or net off-system sales revenues, to

27 ¹³ APS exhibit 18 D shows annual interest of \$5,493,000 compared with no more than one-half million dollars in annual
28 interest with a 7 mil interim PSA adjustor.

¹⁴ Tr. pp. 1078, 1443.

1 the PSA balance is a particularly significant feature of the PSA. This feature has not, as yet,
2 produced the level of mitigation envisioned by the Commission when we approved the Settlement.

3 According to monthly reports filed by APS, the Company's gross revenues from off-system
4 sales for 2005 were approximately \$58.5 million with margins of approximately \$18-20 million
5 before the 90/10 sharing. Contrast these figures with SRP's approximately \$473 million in gross
6 revenues for fiscal year 2005 from off-system sales. SRP does not prepare "net" off-system sales
7 revenue figures but it was able to establish a \$55 million "rate-stabilization fund" derived primarily
8 from these revenues. This fund may allow SRP to avoid passing on to its customers approximately
9 \$40 million in fuel and purchased power costs associated with outages at the Palo Verde Nuclear
10 Generating Station ("PVNGS"), while APS has a pending surcharge application seeking recovery of
11 \$44.6 million associated with these same unplanned outages at PVNGS.

12 In Decision No. 67744 Staff was directed to commence a review of APS' off-system sales
13 practices within three years of the effective date of the Order. Because of APS' disappointing off-
14 system sales revenues, it is imperative that said review take place as part of the pending permanent
15 rate proceeding. The review should compare APS' off-system sales revenues and practices with
16 other electricity providers in the West. The review should also include an analysis of Pinnacle West
17 Capital Corporation, its affiliates and subsidiaries' wholesale energy sales, including, but not limited
18 to, how these wholesale transactions impacted, if at all, APS' off-system sales revenues. We expect
19 the parties to fully explore ways of increasing APS' off-system sales revenues that will benefit both
20 the Utility and its customers.

21 We reject APS' request to eliminate the 90/10 sharing and will not modify the amount of
22 2006 costs that APS can recover either now or in the general rate proceeding.

23 Rate Design

24 APS, Staff and RUCO support any recovery of increased purchased power and fuel costs
25 being applied to customers' bills on a per kWh charge basis. They believe that both the base rates
26 and the PSA currently collect fuel and purchased power through a per kWh charge, so any additional
27 costs that are collected should also be recovered on a per kWh basis. AECC argues that the costs
28 should be collected as an equal percentage increase to customers' base bills because it believes that it

1 is inappropriate in the context of an emergency rate filing to put in place disproportionate increases
2 on different customer groups. AECC/Phelps Dodge argues that high-load factor E-34 customers
3 could experience percentage increases that are 70 percent higher than the system average. The FEA
4 agreed with AECC's recommendation, arguing that E-34 customers could experience rate increases
5 of as much as 20 percent, depending on load factor.

6 In its post-hearing brief, AECC/Phelps Dodge proposes a compromise that incorporates
7 elements of both rate design proposals. The compromise would first allocate the emergency amounts
8 to be recovered to both Residential customers and Non-Residential customers as a whole on a cents-
9 per-kWh basis as proposed by APS. Then the emergency surcharge on Residential customers would
10 be determined on a flat cents-per-kWh basis, and the emergency increase allocated to Non-
11 Residential customers would be recovered through an equal-percentage surcharge on all Non-
12 Residential customer base bills as AECC/Phelps Dodge proposed. Under this compromise proposal,
13 the Residential customers would pay the same way as they would under the APS rate design, and
14 Non-Residential customers would each pay an equal-percentage surcharge.

15 There is merit in both approaches and in the compromise proposal, but because these are
16 energy costs that are recovered through the PSA mechanism, we find that it is appropriate to collect
17 these costs through the PSA's kWh charge. If this were an emergency rate increase unrelated to costs
18 normally passed through an adjustor mechanism, then perhaps we would be more inclined to apply
19 the increase as a percentage on bills. There is no reason to alter the formula for collecting the costs
20 solely because they are being collected sooner. We encourage industrial and commercial customers to
21 address the issue of rate design in the pending rate case.

22 **\$776.2 MILLION "CAP"**

23 In Commission Decision No. 68437, the Commission amended Decision No. 67744 and
24 allowed APS to defer costs above the \$776.2 million "cap" pending resolution in this docket. Staff
25 supports the continued waiver of the \$776 million cap until the permanent rate case is decided. No
26 party proposed resolving the issues relating to the \$776.2 million cap in this docket, and there appears
27 to be general agreement that those issues should be resolved in the pending permanent rate case.
28 Until that time, APS should be allowed to continue to defer those costs.

MISCELLANEOUS ISSUES

1
2 In its Post-Hearing Brief, APS argues that any changes to the 90/10 sharing requirement
3 should not be considered in this proceeding. "Although it is true that APS believes that the 90/10
4 sharing arrangement should not be applied to unexpectedly large fuel and purchased power and that a
5 delay in resetting the base rate cost of fuel in the general rate case should not work to the detriment of
6 APS, those are matters that can be addressed in the general rate case and need not be addressed in this
7 proceeding. For present purposes, it would be sufficient for the Commission to specify that any
8 interim rate increase approved by the Commission will preserve for the general rate case the issue of
9 whether and to what extent APS will be required to absorb 10% of that interim rate increase when the
10 Commission establishes a new base rate in the general rate case." APS Post-Hearing Brief at p. 34.
11 Since we are not authorizing an interim rate increase, there is no reason to "preserve" this issue for
12 resolution in the general rate case. If APS also means by that language that the Commission may
13 want to modify the Settlement Agreement and Decision No. 67744 in the general rate case to remove
14 the 90/10 sharing of the 2006 costs, we are clearly not "preserving" any such issue. The Settlement
15 Agreement and Decision No. 67744 are still in effect and any proposal to modify the amount of costs
16 that APS is allowed to recover is substantive and entirely different from the procedural issue of the
17 timing of collection of authorized costs.

18 In its Closing Brief, Western Resource Advocates states that this proceeding is concerned
19 with short run solutions to APS' financial situation. WRA believes that long term solutions cannot
20 be addressed in this proceeding, but should be addressed in APS' pending permanent rate case and in
21 other proceedings. WRA believes that APS should reduce its dependence on fossil fuels for the
22 production of electricity, and should look to significantly reducing demand for electricity through
23 large scale, sustained energy efficiency programs, and use low cost renewable energy resources as a
24 hedge against high fossil fuel costs. We agree that APS should be looking at ways to diversify its
25 resources.

26 APS also argues in its Post-Hearing Brief that interim relief should not be conditioned or
27 made subject to expense or dividend restrictions imposed on APS. APS believes that although the
28 Commission can examine and exclude imprudent costs in the general rate case, it "would be

1 inappropriate for the Commission to involve itself in internal corporate governance by dictating,
 2 directly or indirectly, whether and to what extent APS should advertise or sponsor local organizations
 3 with shareholder funds.” APS Post-Hearing Brief, p. 36 APS believes that interim rate relief solely
 4 to recover deferred fuel and purchased power costs should not be conditioned on APS cutting
 5 unrelated expenses or be subject to further restrictions on dividends paid by APS. APS notes that it
 6 has already engaged in substantial cost cutting as a matter of corporate policy, and no party to the
 7 proceeding asserted that any of APS’ costs or expenses are excessive or inappropriate. APS
 8 witnesses testified that the expenses are small and most of the advertising and sports sponsorship
 9 expenses are not included in the company’s cost of services charged to APS customers.

10 In light of the growing costs of fuel and purchased power, we are concerned about the rate
 11 impacts on customers. APS should also share that concern and take all steps necessary to reduce its
 12 cost of service, which we will analyze in its rate case. However, APS should also look for ways to
 13 improve its cash flow, even looking at expenses that are borne by shareholders and not ratepayers,
 14 especially when the credit rating agencies are focusing on its FFO/Debt ratio.¹⁵ Accordingly, while
 15 we are not imposing restrictions on APS dividend payouts or dictating that certain expenses be
 16 eliminated in this proceeding, we expect APS to manage its operations in such a manner (including
 17 its generation assets) that with the relief granted herein, together with the measures that APS itself
 18 adopts, its business profile returns to 5, its FFO/Debt ratio continues to improve and its credit rating
 19 remains investment grade.

20 We are particularly concerned about the rate impacts the growing costs of fuel and purchased
 21 power will have on the low and fixed-income customers who will be the hardest hit by the increase in
 22 energy costs. Therefore, we will require APS in its pending permanent rate case to propose ways to
 23 implement automatic enrollment in the E-3 and E-4 low income-discount rate schedules for those
 24 customers who participate in applicable means-tested assistance programs such as LIHEAP, Food
 25 Stamps, and Medicaid.

26 * * * * *

27 _____
 28 ¹⁵ Staff exhibit 11 indicates that the 5 mil interim adjustor will raise the FFO/Debt ratio to 17.8 percent and we believe that APS should be able to find ways to further improve that ratio.

1 Having considered the entire record herein and being fully advised in the premises, the
2 Commission finds, concludes, and orders that:

3 **FINDINGS OF FACT**

4 1. APS is a public service corporation principally engaged in furnishing electricity in the
5 State of Arizona. APS provides either retail or wholesale electric service to substantially all of
6 Arizona, with the major exceptions of the Tucson metropolitan area and about one-half of the
7 Phoenix metropolitan area. APS also generates, sells and delivers electricity to wholesale customers
8 in the western United States.

9 2. On January 6, 2006, APS filed with the Commission an application for a \$299 million,
10 or 14 percent, emergency interim rate increase in annual electric revenues and for an amendment to
11 Decision No. 67744, on an interim basis, to remove the \$776.2 million "cap" on total retail fuel and
12 purchased power costs recoverable in rates. In its rebuttal testimony filed on March 13, 2006, the
13 Company modified its request to \$232 million to reflect declines in fuel prices between November
14 2005 and the end of February 2006.

15 3. Intervention was granted to AECC, FEA, RUCO, AUIA, AzAg, Phelps Dodge,
16 IBEW, AWC, WRA, UES, ACAA, Alliance, Wickenburg, AARP, and the Power Group.

17 4. Public comment was heard at the commencement of the hearing on March 20, 2006
18 and approximately 40 public comment letters have been received by the Commission's Docket
19 Control.

20 5. By Procedural Order issued January 26, 2006, the hearing was set to commence on
21 March 20, 2006, and procedural dates were established for the filing of testimony and evidence.

22 6. On February 14, 2006, APS filed notice of publication indicating notice of the
23 emergency application was published in the Arizona Republic on February 4, 2006 as required by the
24 January 26, 2006 Procedural Order.

25 7. The hearing was held as scheduled on March 20, 21, 22, 23, 24, 27, 28, and 29, 2006.
26 Public comment was taken and testimony was presented by APS, Staff, RUCO, the Power Group,
27 AECC/Phelps Dodge, and IBEW.

28 8. On March 30, 2006, AECC/Phelps Dodge filed its Notice of Filing of AECC Late-

1 Filed Exhibit No. 8 (Supplement to AECC Exhibit No. 7).

2 9. On April 7, 2006, 2006, Staff filed its Closing Brief and its late-filed exhibit S-11; on
3 April 10, 2006, RUCO filed its Post-Hearing Brief; on April 11, 2006, APS, AECC/Phelps Dodge,
4 AUIA, Western Resource Advocates, and the FEA filed their post-hearing briefs, and on April 12,
5 2006, the Power Group filed their Post-Hearing Brief.

6 10. In Decision No. 67744 (April 8, 2005) the Commission adopted the parties'
7 Settlement Agreement and approved a PSA.

8 11. In Decision No. 68437 (February 2, 2006), the Commission denied APS' application
9 for a surcharge, accelerated the implementation of the adjustor, and ordered the parties to file a
10 revised Plan of Administration.

11 12. On December 21, 2005, S&P changed APS from a Business Profile 5 to a 6 and
12 downgraded APS' debt to BBB-.

13 13. APS' borrowing costs have increased approximately one million dollars as a result of
14 this downgrade.

15 14. Cost deferrals due to the imbalance between fuel costs and recovery have weakened
16 the Company's FFO/Debt ratio.

17 15. APS believes that absent emergency interim rate relief APS will likely be further
18 downgraded to non-investment grade status.

19 16. APS believes that during the next 10 years it will need to issue almost \$5 billion in
20 long-term debt to finance essential generation, environmental control, transmission and distribution
21 construction programs, and to refinance existing long-term debt and if it is downgraded to junk status,
22 the Company's annual financing costs would increase between \$110 and \$225 million.

23 17. Negative impacts of junk status include difficulty renewing existing credit agreement,
24 collateral calls that could result in liquidity problems, the imposition of onerous terms and conditions
25 in contracts in the wholesale market, and the elimination of access to commercial paper.

26 18. The expected balance in the 2006 Annual Tracking Account on December 31, 2006 is
27 approximately \$247,557,000.

28 19. Based on the facts and evidence presented, Staff concluded that no emergency exists

1 to justify the rate relief sought by APS, but does believe that concern over mounting fuel and
2 purchased power deferrals is legitimate and sufficient to justify some action in this proceeding.

3 20. Staff recommended that the Commission modify the PSA to allow for quarterly
4 surcharge requests.

5 21. Staff's recommendation balances ratepayer and Company interests by allowing the
6 timely recovery of costs and by using actual costs; it addresses the concerns of the credit rating
7 agencies; and it preserves the 90/10 sharing requirement.

8 22. AECC/Phelps Dodge agreed with APS that an emergency existed and proposed
9 recovery of \$126 million of 2006 deferrals through a surcharge to the Annual Tracking Account in
10 order to reach a FFO/Debt ratio of 18 percent.

11 23. RUCO does not believe that an emergency exists, and at the hearing, RUCO testified
12 in support of Staff's proposal, and rejected APS' proposed modifications to make the surcharge
13 automatic upon application.

14 24. An important factor in evaluating whether an emergency exists is whether there is
15 some other form of relief that would address the asserted emergency besides the extraordinary
16 remedy of interim emergency rates.

17 25. APS' existing rate structure already has incorporated one exception to the
18 constitutional fair value finding requirement in the form of the PSA mechanism which was
19 established to address the very "emergency" asserted by APS, recovery of deferred fuel and
20 purchased power costs.

21 26. Given the existence of the PSA mechanism and our ability to modify it in this
22 proceeding, we find that no "emergency" exists.

23 27. The hardship that APS is facing can be addressed through modifications to the PSA
24 mechanism and therefore, there is no reason to invoke another exception to the constitutional
25 requirement by implementing emergency rates.

26 28. It is in the public interest to insure more timely recovery of APS' prudent fuel and
27 purchased power costs.

28 29. Although rates will increase in the short term, APS ratepayers will benefit from the

1 modification to the PSA in the long run by: a reduction in the amount of interest accruing on deferred
2 costs and thereby the amount that ratepayers will pay; by sending more timely and accurate messages
3 to ratepayers as to the actual costs that are being incurred, thereby allowing them to adjust their
4 consumption; and by increasing the likelihood that APS will remain investment grade and thereby
5 maintain the lower capital costs that current rates are based upon.

6 30. Staff's proposal to allow periodic surcharges to collect deferred costs has merit but the
7 timing will not significantly reduce the interest that accrues, nor will it give a very timely price signal
8 that costs have increased and are being incurred.

9 31. Multiple price changes in a short period of time can be confusing to ratepayers and
10 may not send the appropriate price signals.

11 32. The primary benefit of Staff's proposal is that the costs are not recovered until they are
12 known and incurred.

13 33. Under Staff's surcharge proposal, Staff's review of the surcharge application will not
14 be a prudency review, but will only verify calculations and insure that unplanned outage costs are
15 excluded.

16 34. No party testified that APS' purchased power and fuel costs will be at or near the base
17 costs established in Decision No. 67744, and with hedges, APS anticipates a balance in the 2006
18 Annual Tracking Account of approximately \$248 million.

19 35. APS is 85 percent hedged for 2006.

20 36. In order to prevent the build up of a large balance in the 2006 Tracking Account and
21 the amount of interest that will accrue that will need to be collected from ratepayers beginning in
22 February 2007, it is prudent to allow APS to implement an interim PSA adjustor to collect a portion
23 of the 2006 purchased power and fuel costs that are above the base cost established in Decision No.
24 67744.

25 37. This interim PSA adjustor should be set to collect an amount that will leave no more
26 than approximately \$110 million (or the amount that will be collected using a 4 mil bandwidth
27 starting in February 2007 once the 2005 adjustor ends) in the 2006 Tracking Account at the end of
28 December, 2006.

1 38. An interim PSA adjustor for 2006 costs using a bandwidth of 7 mil should be
2 implemented beginning May 1, 2006.

3 39. The interim PSA adjustor will increase the monthly median residential summer
4 customer bill by \$5.73; the monthly average residential summer customer bill by \$7.33; the monthly
5 median residential winter customer bill by \$3.72, and the monthly average residential winter
6 customer bill by \$4.74.

7 40. Pursuant to Decision No. 67744, the PSA requires that low-income customers on the
8 E-3 and E-4 low-income discount rates do not pay either the adjustor rate or any surcharges, and
9 those customers will not pay this interim PSA adjustor rate.

10 41. The implementation of the interim PSA adjustor will reduce the amount of interest the
11 ratepayers will pay by approximately five million dollars and will preserve the 90/10 sharing
12 requirement.

13 42. APS should include a separate schedule for this interim PSA adjustor in its monthly
14 PSA filings and Staff should monitor on an ongoing basis whether APS is correctly accounting for
15 the recovery.

16 43. The amounts collected through the interim PSA adjustor, including any costs
17 associated with unplanned outages, will remain subject to a prudency review at the appropriate time.
18 In addition, all unplanned Palo Verde outage costs for 2006 should undergo a prudence audit by
19 Staff.

20 44. In the event that Staff or any party believes that APS is not implementing the interim
21 PSA adjustor correctly, they should promptly notify the Commission.

22 45. The interim modification to the PSA will not affect APS' earnings, it will only affect
23 the timing of the already authorized recovery of prudent costs paid for fuel and purchased power.

24 46. The modification of the PSA is an interim measure taken to address a significant and
25 growing deferral of fuel and purchased power costs.

26 47. The parties in the pending permanent rate proceeding should propose modifications to
27 the PSA that will address on a permanent basis, the issues with timing of recovery when deferrals are
28 large and growing.

1 48. The parties should also explore other ways to implement a PSA and/or other tariffs
2 that will give more accurate feedback in pricing terms, so that customers can modify their energy
3 consumption in response to price.

4 49. In Decision No. 67744 Staff was directed to commence a review of APS' off-system
5 sales practices within three years of the effective date of the Order. Because of APS' disappointing
6 off-system sales revenues, it is imperative that said review take place as part of the pending
7 permanent rate proceeding. The review should compare APS' off-system sales revenues and
8 practices with other electricity providers in the West. The review should also include an analysis of
9 Pinnacle West Capital Corporation, its affiliates and subsidiaries' wholesale energy sales, including,
10 but not limited to, how these wholesale transactions impacted, if at all, APS' off-system sales
11 revenues. We expect the parties to fully explore ways of increasing APS' off-system sales revenues
12 that will benefit both the Utility and its customers.

13 50. We reject APS' request to eliminate the 90/10 sharing and will not modify the amount
14 of 2006 costs that APS can recover.

15 51. APS proposed, and Staff and RUCO agreed, that any additional costs that are collected
16 should be recovered on a per kWh basis.

17 52. AECC/Phelps Dodge proposed an equal percentage increase for all customer groups,
18 applying an equal percentage surcharge on total customer bills, exclusive of PSA charges.

19 53. In its Post-Hearing Brief, AECC/Phelps offered a compromise that incorporates
20 elements of both rate design proposals.

21 54. Because these are energy costs that are recovered through the PSA mechanism, it is
22 appropriate to collect these costs through the PSA's kWh charge.

23 55. There is no reason to alter the formula for collecting the costs solely because they are
24 being collected sooner.

25 56. The industrial and commercial customers should address the issue of rate design in the
26 pending rate case.

27 57. All parties support the continued waiver of the \$776 million cap until the permanent
28 rate case is decided.

1 58. APS' long-term planning should include ways to diversify its resources in order to
2 achieve and maintain reasonable, stable rates.

3 59. In light of the growing costs of fuel and purchased power, APS should take all
4 appropriate steps necessary to reduce its cost of service while maintaining safe and reliable service.

5 60. APS should also look for ways to improve its cash flow, including looking at expenses
6 that are borne by shareholders and not ratepayers, especially when the credit rating agencies are
7 focusing on its FFO/Debt ratio.

8 61. Although we are not, at this time, imposing further restrictions on APS dividend
9 payouts or dictating that certain expenses be eliminated, we do expect APS to manage its operations
10 in such a manner (including its generation assets) that with the relief granted herein, together with the
11 measures that APS itself adopts, its business profile returns to 5, its FFO/Debt ratio continues to
12 improve and its credit rating remains investment grade.

13 62. Because the Commission is particularly concerned about the rate impacts the growing
14 costs of fuel and purchased power will have on the low and fixed-income customers who will be the
15 hardest hit by the increase in energy costs, we will require APS in its pending permanent rate case to
16 propose ways to implement automatic enrollment in the E-3 and E-4 low-income discount rate
17 schedules for those customers who participate in applicable means-tested assistance programs such as
18 LIHEAP, Food Stamps, and Medicaid.

19 63. Staff's recommendation that APS file monthly reports on APS' and Pinnacle West
20 Capital Corporation's cash position and financial ratios, including their projected cash flows, until the
21 pending general rate proceeding is resolved is reasonable and should be adopted.

22 64. APS has declared itself to be in a state of financial duress that it claims warrants
23 emergency rates. We believe that a responsible Company making such claims in these circumstances
24 would cut unnecessary expenses, including "branding" related advertising, sports sponsorships,
25 luxury sports suites and season tickets to sporting events. In response to questions from
26 Commissioners, the Company stated that during the past two years it spent more than \$14 million on
27 advertising, luxury sports boxes and sports sponsorships, \$410,000 on season tickets and \$2 million
28 to \$3 million for out of state travel. The Company has also stated that it believes the contracts for the

1 sports sponsorships and some of the related advertising cannot be canceled without incurring
2 cancellation fees and inviting potential litigation. However, some of the sponsorships are scheduled
3 to end in 2006 and 2007, and the Company has stated that the majority of its 2006 advertisements
4 have not yet been placed. We believe that as a responsible Company, APS would immediately begin
5 eliminating some of these discretionary expenses. The resulting savings could be put to better use for
6 both shareholders and ratepayers if APS used the savings to establish a Rate Stabilization Fund
7 designed to shield customers from possible future rate increases. We do not believe the Commission
8 should gratuitously inject itself into decisions relating to corporate management. However, the
9 circumstances of this case suggest APS and the Commission work collaboratively to ease APS' cash
10 flow burden. This requires the Commission to focus its attention on both APS' expenditures and
11 revenues. We therefore believe this finding is appropriate and in the public interest.

12 65. In response to the need for additional operating funds, the Company's Board of
13 Directors voted to eliminate bonuses for APS' executive managers ("officers") in 2006, resulting in a
14 savings of between \$4 million and \$6 million. However, APS paid out approximately \$29.9 million
15 in incentives to other employees in 2006, including \$1.9 million to more than 50 senior managers.
16 The Commission believes that at a time when APS is asking for multiple rate increases, funds that
17 might be used for such bonuses could be better directed toward mitigating the impact of rate
18 increases on the Company's customers. We believe that APS in 2007 should continue to disallow
19 bonuses for its executive managers ("officers"), as well as the Company's 50 senior managers. The
20 resulting savings could be put to better use for both shareholders and ratepayers if APS used the
21 savings to fund a Rate Stabilization fund, as discussed herein.

22 66. Throughout the course of the hearings on this matter the issue of requiring APS to
23 conduct a benchmarking study on the effectiveness of its natural gas purchasing practices was
24 addressed by the parties. The Commission has ordered at least one other utility to engage in
25 benchmarking studies, most recently in the Southwest Gas rate case. Therefore we find that APS
26 should engage in a benchmarking study on their fuel costs and hedging practices. We direct APS to
27 work with Staff to file within 180 days of the effective date of this decision, as a compliance item in
28 this docket, the benchmarking study as prescribed herein.

67. During the hearing questions were posed to APS about natural gas storage and efforts the Company is taking to develop such storage in Arizona. Natural gas storage will be beneficial for the Company particularly because the Company derives the majority of its power from purchased power or natural gas fired plants. Therefore we find that APS should file with Docket Control, by December 31, 2006, a report on the efforts that they are taking, either unilaterally or with other companies, to develop natural gas storage in Arizona.

CONCLUSIONS OF LAW

1. Arizona Public Service Company is a public service corporation within the meaning of Article XV of the Arizona Constitution and A.R.S. §§ 40-203, 204, 221, 250, 251, and 361.

2. The Commission has jurisdiction over Arizona Public Service Company and the subject matter of the application.

3. Notice of the application was provided in accordance with the law.

4. Notice was given that the Commission would consider this matter pursuant to A.R.S. § 40-252.

5. No emergency exists to warrant the implementation of emergency interim rates.

6. The PSA mechanism adopted in Decision No. 67744, should be modified on an interim basis pursuant to A.R.S. § 40-252 to allow for an interim PSA adjustor to collect a portion of the 2006 purchased power and fuel costs during 2006, instead of 2007.

7. The pending general rate proceeding is the appropriate proceeding to address the "cap" of \$776.2 million adopted in Decision No. 67744, and until the issue is resolved in that proceeding, APS may continue to defer fuel and purchased power costs in excess of that cap.

8. The pending general rate proceeding is the appropriate proceeding to address permanent modifications to the PSA mechanism.

ORDER

IT IS THEREFORE ORDERED that Arizona Public Service Company is authorized to implement an interim PSA adjustor for purchased power and fuel costs incurred in 2006, consistent with the discussion herein, to become effective May 1, 2006.

IT IS FURTHER ORDERED that Arizona Public Service Company shall provide its

1 customers notice of the interim PSA adjustor in its next monthly billing, in a form that is acceptable
2 to Staff.

3 IT IS FURTHER ORDERED that Arizona Public Service Company's request for an
4 emergency interim rate increase is hereby denied.

5 IT IS FURTHER ORDERED that all unplanned Palo Verde outage costs for 2006 should
6 undergo a prudence audit by Staff.

7 IT IS FURTHER ORDERED that Arizona Public Service Company shall modify its monthly
8 Power Supply Adjustor filings to include the separate interim PSA adjustor schedule as set forth
9 herein.

10 IT IS FURTHER ORDERED that Arizona Public Service Company shall file monthly reports
11 on Arizona Public Service Company's and Pinnacle West Capital Corporation's cash position and
12 financial ratios, including their projected cash flows, until the pending general rate proceeding is
13 resolved.

14 IT IS FURTHER ORDERED that the issue of the timeliness of recovery of fuel and
15 purchased power costs and any permanent modifications to Arizona Public Service Company's
16 Power Supply Adjustor shall be further addressed in the pending general rate proceeding.

17 IT IS FURTHER ORDERED that Staff shall commence a review of APS' off-system sales
18 practices as part of the pending permanent rate proceeding, including a comparison of APS' off-
19 system sales revenues and practices with other electricity providers in the West. The review shall
20 also include an analysis of Pinnacle West Capital Corporation, its affiliates and subsidiaries'
21 wholesale energy sales, including, but not limited to, how these wholesale transactions impacted, if at
22 all, APS' off-system sales revenues. The parties will fully explore ways of increasing APS' off-
23 system sales revenues that will benefit both the Utility and its customers.

24 IT IS FURTHER ORDERED that Arizona Public Service Company and Pinnacle West
25 Capital Corporation shall take appropriate steps to insure that Arizona Public Service Company's
26 financial ratios remain investment grade.

27 IT IS FURTHER ORDERED that as part of its pending permanent rate proceeding APS shall
28 propose ways to implement automatic enrollment in the E-3 and E-4 low-income discount rate

1 schedules for those customers who participate in applicable means-tested assistance programs such as
2 LIHEAP, Food Stamps, and Medicaid.

3 IT IS FURTHER ORDERED that APS shall, in consultation with Staff, hire an outside
4 consultant to conduct a benchmarking study on their fuel costs and hedging practices. Further, APS
5 shall work with Staff to file within 180 days of the effective date to this decision, as a compliance
6 item in this docket, the benchmarking study as prescribed herein.

7 IT IS FURTHER ORDERED that APS shall file with Docket Control, by December 31, 2006,
8 a report on the efforts that it is taking, either unilaterally or with other companies, to develop natural
9 gas storage in Arizona.

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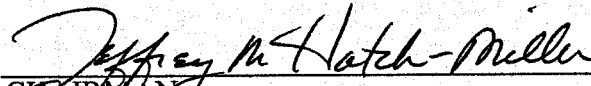
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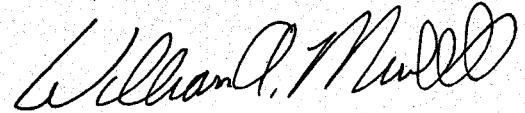
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1 IT IS FURTHER ORDERED that Arizona Public Service Company may continue to defer
 2 fuel and purchased power costs in excess of the \$776.2 million "cap" referenced in Decision No.
 3 67744 until the issue has been further examined in Docket No. E-01345A-05-0816.

4 IT IS FURTHER ORDERED that this Decision shall become effective immediately.

5 BY ORDER OF THE ARIZONA CORPORATION COMMISSION.

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 7 
 8 CHAIRMAN

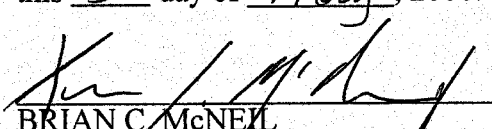

 COMMISSIONER

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 12 COMMISSIONER

COMMISSIONER


 COMMISSIONER

13
 14 IN WITNESS WHEREOF, I, BRIAN C. McNEIL, Executive
 15 Director of the Arizona Corporation Commission, have
 16 hereunto set my hand and caused the official seal of the
 17 Commission to be affixed at the Capitol, in the City of Phoenix,
 18 this 5th day of May, 2006.

19
 20 
 21 BRIAN C. McNEIL
 22 EXECUTIVE DIRECTOR

23
 24 DISSENT 
 25

26
 27 DISSENT _____
 28

LF:mj

SERVICE LIST FOR:

ARIZONA PUBLIC SERVICE CO.

DOCKET NO.:

E-01345A-06-0009

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